United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

No. 75-6066

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IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

P/S

SECURITIES INVESTOR PROTECTION CORPORATION,
Applicant-Appellant,

SECURITIES AND EXCHANGE COMMISSION, *Plaintiff,*

v.

MORGAN, KENNEDY & CO., INC.;
IRWIN RUDNET AND GERALD RUDNET, *Defendants-Appellees.*

CLAIM OF READING BODY WORKS, INC.
PROFIT SHARING PLAN TRUST, *Claimant-Appellee.*

On Appeal from the United States District Court for the Southern District of New York

REPLY BRIEF OF APPELLANT SECURITIES INVESTOR PROTECTION CORPORATION

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REPLY BRIEF OF APPELLANT SECURITIES INVESTOR PROTECTION CORPORATION

Both Appellees' briefs present argument in support of the determination below that each of Reading's Employees was a separate customer of the Debtor. The appellee Trustees also make two alternative arguments, namely, (a) that each of them should be deemed a separate cus-

tomer of the Debtor if this Court should hold that each of Reading's Employees was not, and (b) that the Trust's claim was one for cash and securities, rather than for cash only. This reply brief will address all three issues in the foregoing order.

Readings' Employees as Separate Customers

The appellees do not dispute SIPC's presentation of the legislative history of the 1970 Act and its adoption of section 60e of the Bankruptcy Act in the particulars so important to this appeal (SIPC's Brief at 7-17). Instead they eschew all reference to section 60e as "unjustified" and "inappropriate" (Bondy's Brief at 12; Trustees' Brief at 14-15), apparently for the reason that the 1970 Act made SIPC's funds available to augment the claims of securities customers for the "net equity" of their accounts. This is radical argumentation, indeed, since Congress with full awareness of its remedial objectives expressly embraced the definitions in section 60e "with the meanings there established" (SIPC's Brief at 7).

The appellees appear to view the 1970 Act as a statutory analogue which looks to FDIC and FSLIC regulations for the attainment of a substantial segment of its purpose. In pressing a construction by analogy, at first blush they appear to urge the resolution of an alleged ambiguity (Bondy's Brief at 8; Trustees' Brief at 11). However, closer analysis reveals that they actually hypothesize a statutory void which they would fill by engrafting regulations whose promulgation was justified only by specific congressional grant in unrelated, albeit similarly purposed, legislation. Whatever might be said of the 1970 Act in other contexts, there is neither an ambiguity nor a void which could permit the result urged by the appellees.

The cornerstone of the appellees' contentions is the asserted similarity between the 1970 Act and the FDIA and FSLIA (Bondy's Brief at 11; Trustees' Brief at 13-14).

As the argument goes, the "schemes" of these statutes are so similar that, as one appellee puts it: "It seems reasonable that the term 'customer' under the 1970 Act *should be* similarly defined [as 'insured deposit']". (Trustees' Brief at 17) (emphasis added). Actually the proposition is totally *unreasonable*. First, the definition of "customers" in the 1970 Act is clearly intended to be complete. As demonstrated in SIPC's Brief (at 23), in contrast to other matters neither SIPC nor the SEC were given authority to define or redefine "customers". There is no basis for recourse to other legislation to fill in nonexistent alleged interstices. Secondly, any similarity between the 1970 Act and the FDIA or FSLIA stops at the threshold of their manner of funding and broad socio-economic objectives. It is patent distortion to state that "[t]he scheme [of the 1970 Act] is intentionally similar in almost every respect to other insurance statutes [FDIA and FSLIA] previously enacted by Congress." (Trustees' Brief at 13-14; see Bondy's Brief at 11.) Equally inappropriate are the appellees' borrowings from the first Senate hearings which referred to a "Federal Broker-Dealer Insurance Corporation" (Bondy's Brief at 9, 11; Trustees' Brief at 11-12), a concept subsequently abandoned by Congress (SIPC's Brief at 8, 15-16, 19-21).

Not only does the appellees' position lack support in the language, history and intent of the 1970 Act, but it lacks support in logic. Their theme is a supposed parity of treatment under the 1970 Act, the FDIA and FSLIA. Problems abound. For example, if it is their contention that FDIC or FSLIC regulations extant on the effective date of the 1970 Act should govern, what shall become of parity if those regulations change? If in the interest of parity they would suggest that construction of the 1970 Act should adjust to conform to changes in those regulations, what principle of statutory construction would support them? Could it be that the extent of protection under the 1970 Act was unwittingly vested *sub silentio* by Con-

gress in the FDIC or FSLIC, or both, subject to change as their discretion may dictate? These questions answer themselves. However similar may have been the broad objectives of these legislative enactments, there is no basis for forcing the precise parameters of one upon the other. In each case the Congress chose its methods, and the 1970 Act cannot be made to borrow from the regulations of the FDIC or the FSLIC, or both.

The appellees would justify their unique method of construction by tarring SIPC with the same Kafkaesque brush. Pointing to SIPC's Series 100 Rules, they erroneously urge that SIPC too has found it necessary to flesh out the statutory definition of "customers" by looking to parties in interest behind the persons who held the securities accounts with the debtor (Bondy's Brief at 13, 18-19; Trustees' Brief at 15-17). And thus they demand "consistency" from SIPC (Bondy's Brief at 19) and insist that the real parties in interest here are the 108 Reading Employees who should be considered customers of the Debtor under section 78fff(c)(2)(A)(ii). This entire exercise misconceives the thrust and purpose of SIPC's rules. Only brief comment is necessary to augment SIPC's main brief (at 21-23) in this regard.

Obviously the Congress, not SIPC, adopted the definition of customers in section 78fff(c)(2)(A)(ii). It also included in such customer's "net equity" the value of his "account or accounts" [§ 78fff(c)(2)(A)(iv)], in contrast to section 60e,[1] and it limited protection from SIPC's funds to $50,000 for each customer's "net equity" [§ 78fff(f)(1)]. Had Congress left matters in this posture, each customer (as defined) would have been limited to $50,000 protection irrespective of the different capacities in which he held different accounts. In order to avoid this untoward result Congress added that for purposes of

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[1]This and other changes from section 60e are discussed at pages 12-13 of SIPC's main brief.

the "net equity" definition, "accounts held by a customer *in separate capacities* shall be deemed to be accounts of separate customers" [§ 78fff(c)(2)(A)(iv)] and that, for purposes of protection from SIPC's funds, "a customer who holds accounts with the debtor *in separate capacities* shall be deemed to be a different customer *in each capacity*" [§ 78fff(f)(1)(B)] (emphasis added). Clearly Congress was not redefining "customers" so as to multiply protection by the number of ultimate parties in interest. Without changing the basic thrust of the class included in the definition of "customers", it merely expanded protection by the number of "capacities" in which a customer (as defined) held accounts. The focus was only upon the customer's "capacity", not upon the number of persons on whose behalf he may act in the same capacity. This alone is sufficient refutation of the appellees' contention and the decisions below.

Turning to SIPC's Rules, they purport to do no more than Rule 100(a) states, namely:

> "The rules set forth in this Series will be applied by SIPC in determining, *for the purpose of Section 6(c)(2)(iv) and Section 6(f)(1) of the Act*, what accounts held with a member of SIPC are to be deemed accounts of a 'separate customer'." (emphasis added).

The statutory provisions regarding "separate capacities" held the potential for uncertainty. As a matter of fairness SIPC publicized its views. They are obviously open to challenge in court (SIPC's Brief at 22-23), but they can hardly be used as leverage for attempts to explode Congress' basic definition of customers into a headcount of beneficial interests, parties in interest, etc.

Committed to a course of analogy and extra-statutory extrapolation, the appellees' briefs pay but scant attention to the relevant statutory language. They argue that

(a) the language of section 78fff(c)(2)(A)(ii) shows that the definition of "customers" contemplates

persons who did *not* deal with the Debtor as well as those who did (Bondy's Brief at 7), and

(b) Reading's Employees may be said to have claims against the Debtor within the meaning of that section (Bondy's Brief at 7, Trustees' Brief at 9-10).

Each argument lacks merit for all the reasons already briefed by SIPC, and the following as well.

The alleged inclusion of persons who did not deal with the Debtor is said to be inferrable from so much of the customer definition as parenthetically states "... including persons with whom the debtor deals as principal or agent" (Bondy's Brief at 7). As the Trustees' Brief (at 7, n. 4) correctly concedes, this language was inserted solely to overrule *Gordon* v. *Spalding*, 268 F.2d 327 (5th Cir. 1959) which construed the section 60e reference to "stock-*brokers*" as denying "customer" status to a customer with whom a debtor dealt as principal (a dealer) rather than as agent (a broker) (SIPC's Brief at 14, n.14). See also *Weis Securities, Inc.; Gans* v. *Redington*, CCH Fed. Sec. L. Rep. ¶ 94,780, p. 96,576 (S.D.N.Y. 1974). It was not intended to do more, and certainly not to do major surgery on the section 60e definition of customers, by implication.

Regarding the alleged status of Reading's Employees as persons "who have claims" within the meaning of section 78fff(c)(2)(A)(ii), it seems sufficient to note (a) that they are not creditors of the Debtor in the clear sense of that section and the 1970 Act as a whole, and (b) that only the Trustees are entitled to receive and retain, for trust purposes, any recovery in this proceeding whether from the general estate, the single and separate fund, or via SIPC's funds. Under the Plan, Reading's Employees have no rights to receive anything until termination of employment (as provided), and such interests as they might have in

the trust are specifically inalienable etc. until that time.[2] It is stretching things more than a bit to say, as do the appellees, that "it can fairly be said that each individual 'owns' a portion of the amount owed to the Trust by the Debtor." (Trustees' Brief at 10; see Bondy's Brief at 10).

The appellees urge that Reading's Employees are the "kind of small investors that Congress sought to protect" (Trustees' Brief at 12; see Bondy's Brief at 10). In the face of the statutory language, read in context and in light of the clear legislative history and intent, such generalizations would seem of little value even if true. But the fact is that such a statement suffers from the kind of excessiveness which permeates the appellees' briefs. Indeed, in the court below the application of Bondy went so far as to represent:

> "The beneficiaries of the Trust are factory workers *whose savings make up the funds which were invested by the Trust* Congress was concerned with protecting this very class of small investors when it enacted the 1970 Act." (A 7, ¶ 19) (emphasis added).

This erroneous representation was incorporated in the Trustees' application (A 22, ¶ 1) and clearly influenced the Bankruptcy Judge who thought Reading's Employees had placed "all their wherewithal" with the Trustees (A 33). Both appellees now concede that all contributions to the Trust were made by Reading (Trustees' Brief at 4; Bondy's Brief at 3). Whatever may be said of the interest of Reading's Employees, it is clear they are not customer investors in the sense contemplated by Congress in the 1970 Act, as that sense has been understood by this and other courts (SIPC's Brief at 17-18).

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2 Paragraph 8.1 of the Trust agreement provides: "No benefit under the plan or this Agreement shall be subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge or encumbrance nor to seizure, attachment or other legal process for the debts of the beneficiary." Paragraph 7.2 of the Plan similarly provides.

Brief final note should be made of the appellee's use of section 78fff(f)(1)(D) of the 1970 Act. The Trustees' Brief asserts (at 13) that had they "... dealt with the Debtor through another broker or bank ... the individual claims of the beneficiaries would have been paid by now." This is utterly specious. Reading's Employees would no more be considered the customers of the other broker or bank than they can be of this Debtor. The Trust, no matter with whom it deals, is the customer. Indeed, as demonstrated in SIPC's Brief (at 14-15) this section refutes the appellees' position, including the contention in Bondy's Brief (at 8) that it justifies inclusion in the customer definition of persons who had no dealings with the Debtor.

In the final analysis the appellees' briefs are an errant collage of miscellaneous arguments (even reaching out to the Securities Exchange Act of 1934 [3] and the Employee Retirement Income Security Act of 1974) which are designed to encourage this Court to expand the protection of the 1970 Act in a manner similar to the insurance of certain bank deposits. There is simply no warrant for such expansion in the terms or legislative history of the 1970 Act. However laudable or desirable may be the regulations of the FDIC or FSLIC, the fact is that Congress made its independent determinations when it adopted the 1970 Act. It defined "customers" in precise statutory language borrowed from section 60e "with the meanings there established". That language and that meaning, as SIPC's main brief amply demonstrates, contemplates only the usual securities customers of the bankrupt broker-dealer who have securities accounts and claims with respect thereto. This was a deliberate choice by Congress, not SIPC. Nothing in SIPC's Series 100 Rules does or could affect the issue herein.

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3 The appellees erroneously state that the 1970 Act "is to be treated as an amendment" to the Securities Exchange Act of 1934 (Bondy's Brief at 20; Trustees' Brief at 18). See *Exchange Nat. Bank of Chicago* v. *Wyatt*, 517 F.2d 453, 456 (2d Cir. 1975); see also page 11 of SIPC's brief filed in that case.

The Trustees as Three Separate Customers

The Trustees contend alternatively that each of them should be deemed a separate customer of the Debtor under section 78fff(c)(2)(A)(ii). In the courts below both SIPC and Bondy opposed that position. It was implicitly rejected in each of the opinions below, and the Bankruptcy Judge stated during oral argument:

> "I don't think the trustees are the customers. I think the trust is the customer. How I view the trust - -" (A 40).

The Trustees argue that since they dealt with the Debtor, to give each of them separate customer status would be consistent with SIPC's contentions. SIPC's arguments do not support their position, and elementary principles of trust law, as well as the provisions of the 1970 Act, render their contention untenable.

By their terms the Plan and the Trust involved here are governed by the laws of Pennsylvania.[4] It is the settled law of Pennsylvania and other jurisdictions that co-trustees form but one "collective trustee", that they act in a single joint capacity, and that their powers, interests and authority in the subject matter of the trust are equal and undivided. See, *e.g., Diviney* v. *Lynch,* 372 Pa. 570 (1953); *In re Dorrance's Will,* 333 Pa. 162, 166 (1939); *Coxe* v. *Kriebel,* 323 Pa. 157, 166-167 (1936); *Appeal of Vandever,* 8 Watts &. S. 405, 409 (Pa. 1845); *Hanson* v. *Birmingham,* 92 F.Supp. 33, 42 (N.D. Iowa 1950); *Kane* v. *Lewis,* 282 App. Div. 529, 530 (3d Dep't 1953). Plainly the Trustees here maintained a single trust account in a single collective capacity. No one of them had a separate capacity or could be deemed a "separate customer" under section 78fff(c)(2)(A)(iv) or section 78fff(f)(1)(B) (dis-

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[4] Paragraph 12.1 of the Plan provides: "The plan and the trust agreement shall be construed according to the laws of the state of Pennsylvania." Paragraph 8.5 of the Trust agreement similarly provides.

cussed above at pages 4-5). Together they managed a single trust account which had a single net equity protected to $50,000 maximum under section 78fff(f)(1). No amount of legerdemain could support the idea that the amount of protection accorded trust accounts by Congress depends upon such an arbitrary basis as the number of trustees.

Claim for Cash Versus Securities

The Trustees contend further that only a portion of their claim should be deemed one for cash ($59,598.18), and the balance should be regarded as for securities ($74,336.25) (Trustees' Brief at 28-29). In their view this approach would yield a complete recovery if their principal contention should fail.[5] In the courts below both SIPC and Bondy took the position that the Trust's claim was solely for a cash credit balance of $133,051.15.

This subsidiary issue would require decision on any view of the "customer" question except the one adopted below. It was agreed that the Bankruptcy Judge should not reach this question if he decided that each of Reading's Employees was a separate customer (A 39). Accordingly he subsequently declined to consider it (A 51, n. 1) as apparently did the District Court (A 58-60). As a result, and particularly since the Trustees' argument is not advanced for the purpose of sustaining the orders below, this Court may wish to decline to decide this question for the first time on appeal.[6] However, if it should be

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5 Under section 78fff(f)(1)(A), a customer's "net equity may be satisfied with SIPC's funds up to a maximum of $50,000, but only $20,000 of that sum may be advanced for the portion of the "net equity" which is a claim for cash.

6 *Katz* v. *Carte Blanche Corp.*, 496 F.2d 747, 764 (3d Cir. 1974); see also *Dandridge* v. *Williams*, 397 U.S. 471, 475 n. 6 (1970); *Abbott Laboratories* v. *Gardner*, 387 U.S. 136, 156 (1967); *Swanson* v. *Traer*, 354 U.S. 114, 116-117 (1957); *Jaffke* v. *Dunham*, 352 U.S. 280, 281 (1957); *United States* v. *American Railway Express Co.*, 265 U.S. 425 (1924); 9 Moore's Federal Practice, ¶ 204.11.

reached it is respectfully submitted that the Trustees' position is clearly without merit.

The facts concerning the status of the Trust's account on March 9, 1973, the "filing date" in this proceeding,[7] are set forth in the affidavit of William Ragusin (sworn to on November 27, 1974)[8] who was employed by Bondy to assist in the liquidation of the Debtor. It appears these facts are not in dispute.[9] They may be summarized as follows.

The Debtor's books and records reflected a free credit balance of $133,051.15. That balance resulted from the redemption of a $50,000 U.S. Treasury Bill, and the sale of various securities by the Trustees. There is no question that these sales were authorized by the Trustees, and that they were executed and confirmed by the Debtor. The Debtor delivered most of the securities to the Chemical Bank's Clearance Department, for delivery to purchasers directly or through the Stock Clearing Corporation of Philadelphia ("Philadelphia Clearing"). However, in each case Chemical Bank seized the securities to offset the Debtor's loan obligations. Philadelphia Clearing or the broker-dealer on the other side of the transaction bought-in like shares to cover their short positions caused by Chemical Bank's failure to deliver.

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[7] Under section 78fff(c)(2)(A)(iv), the value of a customer's net equity is computed as of the "filing date" of the proceeding determined as provided in section 78eee(b)(4)(B).

[8] The affidavit was designated as part of the record on this appeal but was not designated by the appellee trustees for inclusion in the Appendix.

[9] Whether and to what extent the Trust's claim might be a claim for securities appeared to present a question of fact before the Bankruptcy Judge (A 27, 39). It was agreed that Bondy would file an affidavit setting forth all relevant facts concerning the Trust's account based on the Debtor's books and records, and that the Trustees' counsel would thereafter advise if he disagreed therewith (A 42, 49). Bondy subsequently filed Ragusin's affidavit. By letter dated December 6, 1974 the Trustees' counsel advised the Bankruptcy Judge: "We see no need to file an Affidavit, since we are in agreement with substantially all of Mr. Ragusin's averments and with exhibits previously filed in this matter before you."

The Trustees' contend that because of the Chemcial Bank's action, these sales were not really consummated and that therefore the Trust's claim should be regarded as one for the securities themselves rather than the cash balance credited to its account. The Trustees offer no authorities in support of their position. For the following reasons, grounded both in the 1970 Act and state law, it is clear that the Trust's claim is for cash only.

Under section 78fff(c)(2)(A)(iv) a customer's net equity is (in effect) the dollar value of his account or accounts computed by subtracting the customer's indebtedness (if any) to the debtor from the sum which would have been owed the customer had the debtor liquidated all securities positions and commitments of the customer on the filing date. The essential inquiry is: "What did the Debtor owe the customer *on the filing date.*" *S.E.C.* v. *Aberdeen Securities Co., Inc.*, 480 F.2d 1121, 1127 (3d Cir.), *cert. denied*, 414 U.S. 1111 (1973) (decided under the 1970 Act); *Cf. Tepper* v. *Chichester*, 285 F.2d 309 (9th Cir. 1960) (decided under section 60e of the Bankrupcy Act). The rights of customers, fixed and determined by the 1970 Act as of the "filing date", supersede any state law remedies in conflict with the 1970 Act, as well as any general reclamation rights in bankruptcy. This was held in *Tepper* v. *Chichester, supra* under section 60e of the Bankruptcy Act. On operative facts strikingly similar to these, it was held that a customer did not have a claim for securities. Although there the customer sought to reclaim securities as distinguished from claiming a securities position for "net equity" purposes, the essential determination applies here. A like result has been reached under the 1970 Act. *Weis Securities, Inc.; Gans* v. *Redington,* CCH Fed. Sec. L. Rep. ¶ 94,780 (S.D.N.Y. 1974).

In determining what was owed the customer on the "filing date", it is appropriate to consult state law which does not conflict with the 1970 Act. *S.E.C.* v. *Aberdeen*

Securities Co., Inc., supra at 1127. Because all significant contacts concerning these transactions were with the State of New York, New York law controls. 60 N.Y. Jur., Transfer of Securities, § 29. The law in New York is well settled that:

> ". . . where there is a contract of present sale of corporate stock, regardless of whether title passes from the seller prior to the delivery or even prior to the transfer on the books of the corporation, the seller is bound to transfer, and the buyer is bound to accept, the shares specified; and the latter becomes the 'beneficial owner' of the stock." 60 N.Y. Jur., Transfer of Securities, § 84, citing *Broderick* v. *Alexander,* 268 N.Y. 306 (1935).[10]

The foregoing as well as other authorities make clear that the sell orders by these Trustees which were fully executed gave rise to the Debtor's firm obligation to pay the sales price, and no other. See *Hewitt* v. *Paine, Webber, Jackson & Curtis,* N.Y.L.J., May 1, 1969, p. S-12 (Sup. Ct. 1969); *accord, McNeil* v. *Tenth Nat. Bank of New York,* 46 N.Y. 325 (1871); *Lieberman* v. *Lincoln Rochester Trust Co.,* 56 Misc. 2d 81 (Sup. Ct.), *aff'd,* 30 A.D. 2d 1049 (4th Dep't 1968).

The Trustees' position amounts to an assertion that following the trades they were entitled to recover the securities from the Debtor. However, the Debtor was under an obligation to deliver them to the purchasers. By making the trades, and then delivering comparisons to the purchasing broker-dealers (see Exhibits I and K to the Ragusin Affidavit), the Debtor became bound to make delivery. See UCC § 8-319(c) and paragraph 2 of the Official Comments thereto; *Tepper* v. *Chichester, supra,* at 312.

It seems clear, without more, that on the "filing date" the Debtor owed the Trust its free credit balance, not

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[10] *Broderick* v. *Alexander, supra,* was decided prior to the enactment of Article 8 of the Uniform Commercial Code in New York. However, that statute did not affect the quoted rule of law.

securities. The liquidation of securities to cash was the entire object and purpose of the Trustees' transactions. The intervening insolvency was unfortunate indeed, but the obligations and expectations of the parties are evident. Had the credit balance been tendered to the Trustees, they would hardly have refused on the ground that they were entitled to securities. Clearly they could not have demanded their securities.

CONCLUSION

The order of the District Court should be reversed upon a determination by this Court that the Trust was the customer of the Debtor, and this Court should either (a) determine that the Trust's claim is entirely for cash, or (b) remand this case for a determination as to the nature of the Trust's claim.

Respectfully submitted,

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Claim of Reading Body Works, Inc. Profit Sharing
Plan Trust

AFFIDAVIT OF SERVICE

I, Charles F. Hooper, an agent of the law printing firm of Byron S. Adams Printing, Inc. of Washington, D. C., do hereby certify that on this 30th day of October, 1975, two copies of a Reply Brief of Appellant Securities Investor Protection Corporation in the above-entitled case were served on the following attorneys by first class mail, with proper postage affixed:

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Charles F Hooper
Charles F. Hooper

SUBSCRIBED AND SWORN TObefore me this 30th day of October, 1975.

Robert W. Price
Notary Public, D. C.
My Commission Expires May 14, 1976

(SEAL)